



THE VIRGINIA STATE BANKER

Regulatory News for Virginia State-chartered Banks
State Corporation Commission - Bureau of Financial Institutions

Commissioner E.J. Face, Jr.

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The Virginia State Banker is published quarterly by the Virginia Bureau of Financial Institutions to provide useful information to the banks and savings institutions that it regulates, and any of their related interests. Reader comments and suggestions are welcome and should be addressed to:

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National Bank Conversion Fee Reduced

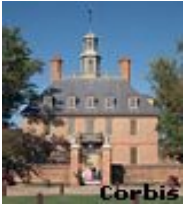
Recently, at the request of Commissioner E. J. Face, Jr., the State Corporation Commission approved a reduction in the application fee from \$10,000 to \$5,000 for conversion of a national bank to a Virginia state bank. This is but another of many internal changes the Bureau has made since Commissioner Face took office July 1, 1997. Methodically, the Bureau is transforming itself to keep pace with continuous changes in the financial services industry, and Commissioner Face still has other ideas in mind.

"I firmly believe in change, if you don't change, you will be left behind" said Commissioner Face. The Commissioner is often reminded of the wisdom of Bobby Bowden, Florida State's legendary head football coach who once said, "I'm not too proud to change. I like to win too much!" Commissioner Face said he still has a number of things to do, all in the fullness of time, all designed to keep the state bank charter the charter of choice, particularly for community banks. The advantages of the state charter still remain – easier access to the primary regulator, greater response to requests, parity of banking statutes, efficiency of regulatory operations, significantly lower assessments, and consistent regulatory policies.

In the last few years, the Bureau has steered through a period of unprecedented industry consolidation and loss of banking assessments. Despite those losses, the Bureau enjoyed an outstanding year in Fiscal 2000. Revenue was up 4.7%, expenditures were well contained advancing only 1.4%, staffing was reduced 8.3%, and the reserve was boosted to a record level. Policies were set in place, processes were rigorously examined for efficiency improvements, and great strides were made in reliance upon technology to enhance timely and efficient operations. The Bureau is well positioned for the potential loss of another large bank provided it adheres to its cost-containment plan.

Other accomplishments of the Bureau include:

- Establishment of the Virginia Bank Director's College
- Establishment of annual Banker CEO Meetings
- Reduction of various application fees and streamlining of applications
- Accreditation from the Conference of State Bank Supervisors'
- Opposing of federal fees on state-chartered banks
- Development of new streamlined, on-site examination software, and
- Establishment of various Bureau newsletters to regulated industries
- Establishment of Mortgage Lender and Broker Orientation meetings.



DIRECTORS' COLLEGE TO BE HELD IN WILLIAMSBURG

In a January 23, 2001 letter to Virginia bank directors, Commissioner E. J. Face, Jr. announced that the spring session of the Virginia Bank Directors' College will be held at the Williamsburg Marriott Hotel on March 29 and 30, 2001.

This educational opportunity was initiated by Commissioner Face in 1998 to make available cutting edge regulatory-related information to those individuals responsible for the affairs of Virginia's banks. It also provides bank directors a relaxed forum to discuss a wide range of issues with Virginia's top bank regulators and their senior staff. While particularly useful for individuals new to bank directorships, the College is open to all bank directors, and the programs offer valuable information to the seasoned director as well. Previous sessions have been well attended by directors having a broad range of experience.

The College is sponsored by the Bureau of Financial Institutions, the Federal Reserve Bank of Richmond, and the Federal Deposit Insurance Corporation. The Virginia Association of Community Banks (VACB) manages the registration process and facilities arrangements. Registration materials are made available by contacting the VACB at (804) 217-8250.

The College is accredited by the American Association of Bank Directors (AABD). The program qualifies as a six-hour core course which will help fulfill the requirements for a certificate of completion available to AABD members.

Due to facility availability, the College is limiting attendance to 60 directors. Final registration must be received by the VACB by March 8, 2001. Commissioner Face and Bureau staff look forward to seeing you this spring in Williamsburg.

John Reich Confirmed to FDIC Board

As the 106th Congress wrapped up its business, John M. Reich, a former banker and chief of staff to retiring Sen. Connie Mack (R-FL), was confirmed Dec. 15, 2000 to a six-year appointment as a member of the FDIC Board of Directors. Mr. Reich previously served as President and CEO of the National Bank of Sarasota and the First Commercial Bank in Fort Myers, Florida.

As a highly regarded staff member on Capitol Hill and Sen. Mack's chief of staff, Mr. Reich also oversaw management of the Joint Economic Committee and the Senate Republican Conference. "Mr. Reich's extensive banking experience and intimate knowledge of Capitol Hill make him a terrific addition to the FDIC Board," says Conference of State Bank Supervisors President and CEO Neil Milner. "John Reich knows banking, and he knows the beltway. That's a great combination."

Community Banks Continue to Expand

For the eleventh consecutive year, the Bureau of Financial Institutions processed a record number of applications for certificates of authority, licenses, branches, and acquisitions. According to Deputy Commissioner Nicholas C. Kyrus, the number of applications processed was nearly 10% higher than in 1999; however, the rate of increase was slower than the previous years, perhaps reflecting the slowdown of the national economy. Since 1990 the number of applications processed by the Bureau has nearly tripled.

During 2000, the Bureau received 1,435 applications, compared with 1,310 in 1999. The majority of the applications were filed by non-depository institutions such as mortgage lender/brokers, money transmitters, and consumer finance licensees. Depository institutions (mainly banks) filed 151 applications compared with 127 in 1999. Bank branch applications accounted for 113, up significantly from the 71 applications filed in 1999.

The significant increase in branch application filings can be explained by the continuous expansion of community banks. The high number of acquisitions and mergers over the last five years resulted in branch consolidations and the sale of existing branch offices. The beneficiaries were the community banks and the banking public.

While the number of applications has been increasing, the Bureau has managed to reduce the processing time of applications without increasing staff. This was accomplished through computerization and streamlining of application procedures. Most branch applications are now acted upon immediately after the end of the 15-day notice published in the Bureau's Weekly Information Bulletin.

EXAM FEES ARE “DOA,” SO OCC TRIES NEW APPROACH

Acknowledging that the Clinton Treasury's campaign for state bank exam fees has been “dead on arrival in Congress” every year since 1993, Comptroller John D. Hawke, Jr. tried a new twist recently. In a speech to the Exchequer Club in Washington, the Comptroller argued that “the dual banking system is hardly ‘dual’.” Hawke said: “The fact is that the predominant regulation of state banks is federal, and the scope of responsibilities of state bank regulators is typically far narrower than that of the respective federal regulator.... In short, the most important division of bank supervisory authority today is not that between the states and the federal government, as may earlier have been the case, but a division among the three federal regulatory agencies.”

What's the Comptroller's up to? It seems he's trying to marginalize state banking supervision and turn this into a fight among federal regulators. Why? He's hoping the Treasury's clout will increase the OCC's budget and put the agency on top with a new Administration and the Congress. Yet Hawke won't share regulatory responsibility, which could lower the OCC's costs. He says it “would increase the supervisory burden on national banks by subjecting them to the jurisdiction of two agencies, instead of one.” It seems he wants it both ways. He wants the FDIC and the Fed to give him money, but he doesn't want their help. It may not make much sense, but you don't need to in the world of Washington spin.

*Reprinted from the December 22, 2000
Examiner Newsletter of the Conference of State
Bank Supervisors*

Conference of State Bank Supervisors

The Conference of State Bank Supervisors (CSBS) has been advancing the goals of the State Banking System since 1902. Recently in response to an inquiry from a state bank about CSBS membership, Commissioner E. J. Face, Jr. noted the benefits of CSBS membership for a bank. The Bureau of Financial Institutions has been an active member of CSBS for many years. Commissioner Face is a Director of CSBS and other Bureau staff serve on various CSBS committees.

The mission of the CSBS is to support the leadership role of the state banking supervisors in advancing the state banking system; ensuring safety and soundness; promoting economic growth and consumer protection; and fostering innovative state regulation of the financial services industry.

- CSBS is the only national organization dedicated exclusively to protecting and advancing the state banking system.
- State banking departments, through CSBS, show their commitment to a strong state system that ensures a viable business option for banks to serve the public. Currently, all 54 state banking departments are dues-paying members of CSBS.
- State-chartered banks choose state regulation because it's efficient, responsive, accessible, and cost-effective. One of the primary goals of CSBS is to maintain and enhance the value of the state banking charter. The state charter has produced almost every innovation in the history of the U.S. banking system, from checking accounts to interstate branching.
- In an interstate environment, the role of CSBS is even more critical in protecting the rights and opportunities of state banking regulation, and CSBS is a recognized voice in Washington representing the needs of state banking departments. In fact, this year CSBS testified numerous times before Congress on behalf of state banking departments outlining key factors impacting the state system in financial modernization legislation.
- CSBS played a pioneering role in the establishment of the Nationwide Cooperative Agreements for interstate bank supervision: one among the state banking departments and one between the states, the FDIC and the Federal Reserve. These revolutionary agreements ensure a seamless system for supervising state-chartered banks that operate across state lines and federal districts or regions.
- For six straight years, CSBS has led the battle against the administration's efforts to impose new federal fees on state-chartered banks. CSBS's active opposition to this proposal has saved the industry an estimated \$1.4 billion. The fact that state-chartered banks haven't paid these fees, and won't pay these fees, is a testament to the credibility and strength of

FDIC Issues Financial Subsidiary Rule

The FDIC recently issued a much-anticipated final rule preserving the ability of state nonmember banks to offer the most innovative state-approved products and services under the long-established Section 24 of the Federal Deposit Insurance Act. The final rule is a reversal of the interim rule announced earlier this year that State Bank Supervisors believed threatened the flexibility of the state charter. It incorporates nearly all changes that State Bank Supervisors advocated by clarifying when and how state nonmember banks must notify the FDIC prior to engaging in activities that national banks are allowed to conduct only in financial subsidiaries.

The Gramm-Leach-Bliley Act (GLB) opened the door for national banks to conduct new activities under a financial subsidiary structure. For years, state banks have been involved in innovation, and have followed the requirements of Section 24 to seek approval of state-authorized activities that national banks could not conduct. There is no change for those state banks with already-approved Section 24 activities. But if any state bank wants to offer a new product or service that national banks can now also offer under GLB, the state bank will have to structure the activity under the rules of GLB's Section 46, and not Section 24.

State Bank Supervisors commented on the FDIC's so-called "24/46" rule during its interim phase. They were pleased the FDIC adopted the following changes in the final rule that CSBS and other parties advocated in comment letters. They include:

- * The definition of a financial subsidiary excludes subsidiaries that conduct activities that the state nonmember bank is permitted to conduct directly. This is consistent with Federal Reserve rules. The action grandfathers equity investment holdings that were previously permissible and also approved under Section 24.
- * State nonmember banks can self-certify that they meet the requirements to carry out financial subsidiary activities under the rule, and the self-certification is effective upon receipt of the notice by the FDIC. There is no waiting period.
- * If a state nonmember bank has obtained Section 24 approval to conduct an activity and the U.S. Treasury Department and the Federal Reserve subsequently approve the same activity for national bank financial subsidiaries, the state nonmember bank continues to operate under Section 24 requirements.
- * State nonmember banks that are grandfathered to hold equity securities under a portion of Section 24 may form new subsidiaries to engage in the same activity that is lawful for these banks at the bank level because of the grandfathered activity.
- * In the absence of guidance or interpretations by the OCC on financial and operational safeguards for national bank financial subsidiaries, the FDIC has the authority on a case-by-case basis to determine such safeguards for state nonmember bank subsidiaries.

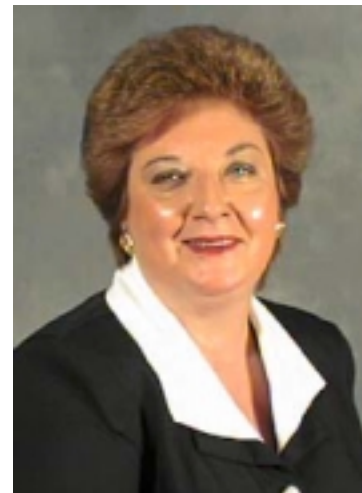
NHEMA Lawsuit Update

In our October 1999 issue of this newsletter, we reported a ruling in the case of NHEMA v. Face, Hancock, and Early. The United States District Court for the Eastern District of Virginia had entered a permanent injunction against Commissioner of Financial Institutions E. J. Face, Jr.; Deputy Commissioner Susan Hancock; and the Attorney General of Virginia prohibiting them from enforcing the limitation in Virginia's prepayment penalty laws against licensed mortgage lenders that entered into so-called "alternative mortgage transactions" in compliance with regulations of the Office of Thrift Supervision. The trial court's ruling was based upon its view of the pre-emptive effect of a federal law known as the Alternative Mortgage Transaction Parity Act of 1982.

Commissioner Face, Deputy Commissioner Hancock, and the Attorney General appealed the case to the United States Court of Appeals for the Fourth Circuit. That Court heard oral argument in the case and has now affirmed the ruling of the District Court. Whether or not the appeal should be pursued is under consideration. In the meantime, the Bureau will continue to assure conformity with Virginia prepayment penalty laws in connection with non-alternative mortgage loan transactions.

BUREAU PROFILE

- **Name:** Mary Lou Kelly
- **Current Position and Years of Service:**
Principal Office Technician; 24 years
- **Main Responsibilities:**
Administrative Assistant to the Commissioner of Financial Institutions
- **Education and Professional Designations:**
John Marshall High School, Braxton Business School, and J. Sargeant Reynolds Community College
- **Family:** Four sons and three grandchildren
- **Personal Interests:** Music, Gardening, Antiques, Travel, and following the stock market



If variety really is the “Spice of Life,” then Mary Lou Kelly’s professional and personal life is not lacking any flavoring! When asked to describe her typical day, Mary Lou states there is no such thing as a typical day in her position as the top administrative assistant to the Commissioner of Financial Institutions, a position she has held since 1980. Over the years, many Virginia bankers have become acquainted with Mary Lou when they have telephoned the Bureau to speak with Commissioner E. J. Face, Jr., or his predecessor, former Commissioner Sidney A. Bailey. Mary Lou finds the daily variety in her work challenging, and she really enjoys seeing how the Bureau works with an ever- changing financial services industry.

With a father in the military, Mary Lou lived in several areas while growing up. She was born in Pikeville, Kentucky, and she lived in Alexandria, Virginia for several years before moving to Richmond in time for her high school years. After completing business school, Mary Lou worked for a mortgage company before joining the Bureau of Financial Institutions in 1977.

Mary Lou states she has learned much from both of the Commissioners she has worked for over the past 21 years. It also appears that the respect is very mutual since Commissioner Face recently stated “Mary Lou is a tremendous asset to me, the Bureau, and the State Corporation Commission. Her vast institutional and legislative knowledge cannot be duplicated. She knows what needs to be done, many times before I know it needs doing! When I became Commissioner in 1997, I said it would have been difficult for me to assume the job without her; she made the transition smooth for me and the Bureau. Today, I cannot imagine doing this job without her!”

When asked to reminisce about her job, Mary Lou said she can recall when all the clerical staff used manual typewriters, and they had to position eight or nine pieces of carbon paper for each original document they were typing. While she admits office technology has made her work easier, she is looking forward to retirement in the future. Once she retires from the Bureau, Mary Lou said she would like to travel, spend time with her grandchildren, and maybe volunteer as a high school teacher, just for a little variety!

Thinking About Credit-Linked Notes?

Credit-linked notes are debt securities that contain embedded credit derivatives. Due to the embedded credit derivative, a credit-linked note is a form of structured note. Credit-linked notes facilitate the transfer of the credit risk associated with a reference asset from a counterparty to the buyers of the notes. Commercial loans and corporate bonds are the most common types of reference assets.

While credit-linked notes have been issued since the mid-1990s, some insured institutions have recently purchased a new type of credit-linked note with speculative characteristics. This new instrument pays investors two distinct and unrelated cash flows: (1) a principal payment at maturity, typically 12 years, equal to the par value of the security and (2) quarterly interest payments tied to the performance of a below-investment-grade asset-backed residual.

From an economic perspective, the purchase price of the credit-linked note can be decomposed into two separate payment amounts: one amount for the principal cash flow at maturity and one amount for the uncertain stream of future interest payments. In some cases, the payment amount for the uncertain interest cash flows may represent over 50% of the total purchase price of the credit-linked note. The principal cash flow is similar to a zero coupon bond, while the interest cash flows resemble an interest-only strip.

The Bureau will expect any bank placing credit-linked notes on their balance sheet to have complete documentation on how they fit into the bank's business plan and how they will be monitored. These notes are not appropriate investments for most banks.

For more information on these, see the FDIC's FIL 88-2000 and its attached Division of Supervision Memorandum.

Credit Card Survey Now Available on the Bureau's Web Site

Information gathered on credit card terms, fees, and charges pursuant to the General Assembly's House Joint Resolution 14 is now available on the Bureau's Web site at <http://www.state.va.us/scc/division/banking/credit.htm>. From the State Corporation Commission's homepage you can select "consumer information," and then in the text click on "Credit Card Survey Information."

The surveys were sent to the top ten credit card issuers in the country; large financial institutions in states adjacent to Virginia; and all of the depository institutions in Virginia. Of the 427 surveys mailed, 289 were returned. Banks responded at a 71% rate and credit unions at a 68% rate. Of the respondents, 141 offer credit cards, and their data is included in the survey.

Survey information is available in several presentations. It can be sorted by interest rate, fees and charges, and grace period. The Web site also provides links to other credit card surveys and information for consumers about credit cards.

Credit Card Sales Transaction Settlements

A recent failed bank case involved credit card and merchant-processing activity wherein a third party handled the processing and paid the bank for the use of its charter to access the payment system. The bank's monitoring of the third-party Independent Service Organization (ISO) was lacking. In order to increase its income, the ISO began using high-risk merchants, and the charge-back rate increased rapidly, leaving the bank with heavy losses and inadequate capital.

Management and the board of any bank providing clearing services needs to be sure the bank has a voice in which merchants an ISO uses.

FFIEC Issues Guidance on the Risks of Outsourcing Technology Services

The FFIEC issued guidance on managing the risk exposure an institution faces when it uses outside firms for technology. The interagency guidance focuses on issues such as risk assessment, service provider selection, contract terms, and oversight of outsourcing arrangements.

As explained in the guidance, the proliferation of new startup service companies with limited experience, resources, and knowledge of the regulated financial services environment, heightens the importance of effective risk-management practices. The federal banking agencies acknowledge that financial institutions and their customers can achieve benefits through outsourcing of products and services. However, the responsibility for managing the risks associated with those products or activities cannot be outsourced.

The agencies urge institutions to ensure that an appropriate risk-management process is in place to identify, measure, monitor, and control the risks associated with technology-related outsourcing arrangements. The guidance can be viewed on the FFIEC's Web site at www.ffiec.gov/press/pr112800.htm

CSBS (Continued from page 3)

CSBS among Washington policy makers. We speak for the state banking system. The 2001 Federal Budget proposal was estimated to have raised approximately \$938 million from state-chartered banks and bank holding companies over five years. On average, a bank's fees would double if this proposal were to take effect.

- CSBS has worked closely with the FDIC in developing GENESYS – a streamlined, on-site examination software program, by providing staff and state regulators to help with the development and training. CSBS is an active participant in the State-Federal Working Group that coordinates the activities and policies of state bank supervision with the FDIC and Federal Reserve.
- The mission of the CSBS Internet Banking Taskforce is to develop a nationwide, coordinated legal and regulatory framework that empowers state-chartered banks to operate competitively on the Internet within safety and soundness parameters. To achieve this overall goal, the Taskforce is working with the Federal Banking Agencies, some of the nation's largest and most progressive state-chartered banks, as well as other functional regulators at the state level.
- Participation in CSBS committees allows members the opportunity to provide direction to CSBS and keep abreast of important developments impacting the state banking industry.
- CSBS provides assistance in coordinating and implementing regulatory efforts between the state and federal regulatory agencies.
- CSBS provides a research database and published reports for specific areas of interest affecting state banking departments.
- CSBS provides quality technical training schools that have been used to train thousands of examiners. Many of the schools are now also available through computer-based training on screen modules and through on-line Internet delivery, allowing for more efficient use of examiner time by reducing the need for travel to on-site locations.
- CSBS provides advanced training programs for senior and experienced examiners, deputies, and superintendents.
- CSBS sponsors a comprehensive state banking department performance Accreditation Program to promote professionalism of state banking departments and their personnel. Forty-four state banking departments have obtained such distinction.
- CSBS offers a certification program for examiners that recognizes their experience and professionalism in specific areas of bank examination. Certified examiners are required to make a commitment to continuing education.
- CSBS hosts the nation's largest gathering of state and federal regulators at its Annual Meeting & Conference, a unique opportunity for bankers and regulators to meet in a collegial setting to discuss issues impacting the state banking system.
- CSBS assists state banking departments in coordinating and planning annual "Days with the Commissioner" for local bankers in their state.
- CSBS, with Compliance International, helped to create the new Books On Screen program, a compilation of all state and federal banking laws, accessible through a single computer or LAN network. Since rules are always changing, software updates are provided every two weeks.
- CSBS provides a network of peers to share concerns, ideas and views on banking industry trends and regulations.
- CSBS provides its members with timely and accurate information on the latest news affecting state banking departments and the banks they serve.